Chapter 2

The Government and Enterprises – A Changing Relationship by Market Competition

Introduction

The performance of SOEs, the major borrowers from state-owned banks, began to deteriorate drastically early in the 1990s. This chapter intends to spotlight the deterioration of business of SOEs as the major cause of bad loans. We examine this issue from the angle of the government-firm relationship.

While there are multiple factors at work behind the deteriorating performance of SOEs, the major factor is without doubt the fact that the government — and in particular local government — in its role as supervisor of the SOEs, burdened them with the fulfillment of various social roles. In this chapter we focus on the two most important roles assigned to state-enterprises, namely, the roles of securing local employment and of promoting local industrial development, and we show how these two are the chief causes for the deterioration of SOE performance. We will also argue that growing market competition is causing the relationship between SOEs and the government to change, and that this change will lead to redefinition of the raison d'être of SOEs.

Section 1
The Framework of the SOE Issue

1. Outline of the Administrative Management of SOEs

We will begin by sketching the institutional framework of government-SOE relationships. China has 270,000 SOEs (non-financial, as of the end of 1996) encompassing practically all business sectors. More than 80,000 SOEs operate in the mining and manufacturing sectors alone. In size, they range from giant firms with 100,000 or more employees to small firms with 100 or so employees (Table 1). Given this diversity, it is impossible to unitarily manage all of them from a single center. Thus, only 5% of the SOEs are controlled directly by the central government and **the majority left to the supervision of local governments from provincial through municipal to county levels**. This chapter takes as the typical model local government-controlled SOEs in the mining and manufacturing sector.

These SOEs are each affiliated to, and subject to control by, the municipal government office for the industry sector to which the SOE belongs. Under the planned economy system, these supervisory offices functioned as the channels through which the state economic plan was communicated to SOEs.

Table 1 Outline of Mining and Manufacturing SOEs (1995 census)

	No. of firms	No. of employees (in 10,000)	Average number of employees	Average output value (in 10,000 yuan)	Average asset (in 10,000 yuan)
Mining and manufacturing enterprises	7,259,822	14,367	20	111	120
State owned	87,905	4,465	508	2,945	5,400
Centrally controlled	4,738	1,092	2,305	18,997	35,563
Local government-controlled	83,167	3,373	406	2,031	3,682
Provincial of municipal level	33,044	2,244	679	3,556	6,924
Country level	50,123	1,129	225	1,025	1,545
Large enterprises	4,685	1,854*	3,957*	33,954	63,811
Medium enterprises	10,983	1,091*	993*	4,828	8,605
Small enterprises	72,237	1,317*	182*	648	1,125

Notes:
(1) figures with asterisks are for 1994.
(2) The average asset does not cover enterprises with annual sales of 1 million yuan or more.
Source: Compiled from the Third Industrial Census and other data

Table 2 Acquisition of Rights of Autonomy by SOE Management (1996 Survey)

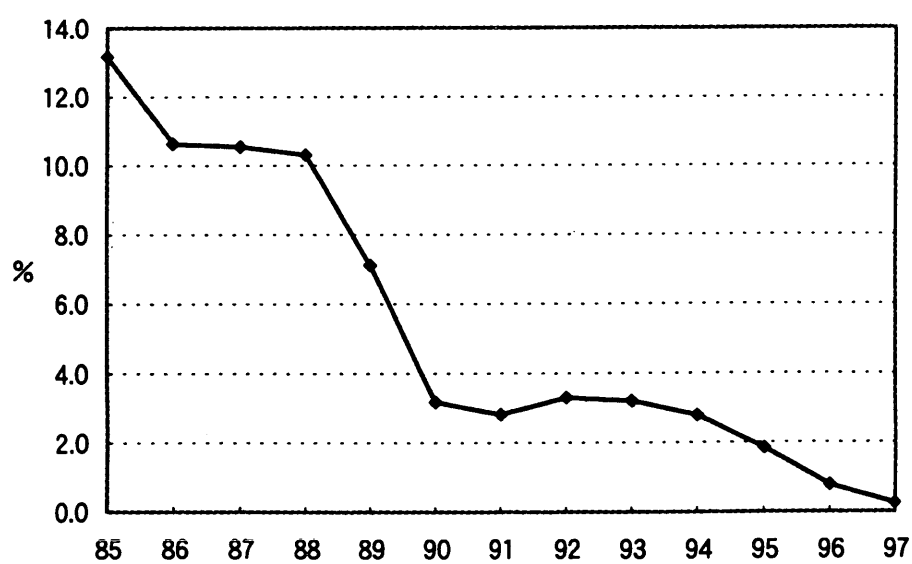
	Time when autonomy was acquired				Autonomy not yet acquired
	1985 or before	1986 to 90	1991 to 93	1994 or after	
Right to decide output volume and product lines	31.5	35.4	18.6	1.0	13.5
Right to decide on product prices	18.9	34.4	23.6	1.5	21.7
Right to recruit and hire employees	9.2	27.5	22.8	3.1	37.4
Right to dismiss employee	5.9	21.7	19.4	4.7	48.4
Right to exporting products	2.3	11.4	9.8	2.1	74.3
Right to importing products	1.5	8.7	9.7	1.8	78.1
Right to decide on investment projects for recouping within 2 years	3.5	10.5	11.3	1.4	73.3
Right to decide on investment projects for recouping in 2 years or more	3.4	9.2	10.7	0.6	76.1
Right to purchase assets	6.5	11.5	11.8	1.9	68.3
Right to dispose of assets	3.1	8.3	10.3	2.6	75.6

Note: The figures represent shares in the total of the samples.
Source: OECF-RIDA data (800 samples)

Even in the middle of the 1980s when SOE reform was put into practice, SOEs were generally functioning merely as production units. They were factories, rather than firms.

During the reform process in the second half of the 1980s, the SOE management autonomy was strengthened in an effort to make them function as firms. **In 1987 to 88, a contract responsibility system was introduced into most SOEs, under which management was given more power in day-to-day operation**. By 1993 when the contract responsibility system was abolished, about 80% of the SOEs had acquired management autonomy in their routine activities, according to a survey conducted in 1996 jointly by the Research Institute of Development Assistance of the Overseas Economic Cooperation

Figure 1 Declining SOE Profit Rates



Note: Asset-profit rate of mining and manufacturing enterprises (pre-tax profit as a proportion of gross assets)
Source: *Statistical Yearbook of China* (in relevant years)

Fund and the Institute of Economics of the Chinese Academy of Social Sciences (OECF-CASS joint research) (Table 2).[1] A number of studies measuring total factor productivity (output growth minus the contributions by labor and capital input increments) confirm that the extended managerial autonomy resulted in definite improvements to production efficiency.

2. Patterns of Deterioration in SOE Performance

Despite the improvement in productivity resulting from reform, the SOE performance systematically deteriorated in the second half of the 1980s (Figure 1). In the 1990s, the pace of deterioration actually accelerated. Both the size of deficit and the percentage of the firms running into deficit temporarily declined in the middle of the 1980s but then began to grow again in the 1990s.

Why has business performance deteriorated despite the progress in reforms? **Two major immediate causes are cited: excessive distribution (to labor) and excessive investment**. Since the mid-1980s, the rate of wage and investment increases in SOEs has almost without exception exceeded production increases. In addition to cash wages, fringe benefit expenditures have also drastically increased, pushing up labor costs. For this reason, the labor-intensive SOE sub-sectors lost competitiveness to the emergent non-SOEs — especially village and township enterprises whose labor costs were low. Of the SOEs, the smaller ones were the first to experience business deterioration. The OECF-CASS survey showed that Chinese non-SOEs were the major competitors of the SOEs (Table 4).

It is interesting to note that "other SOEs" also emerged as SOEs' second toughest rivals. As can be seen in Figure 2, investment in the state sector bounced ahead in every investment boom. New SOEs were also set up, causing the number of SOEs to continue to increase until the middle of the 1990s. Due to excessive investment, SOEs' productive capacity decreased inordinately, causing capacity utilization rates also to go down. In the 1990s, even in the heavy industrial sector with a high entry barrier to newcomers, SOEs began to suffer from poor performance largely as a result of their over-investment.

Table 3 Size of Deficits Incurred by SOEs

	Deficits of all SOEs (in 100 mil. yuan)	Deficits of mining & manufacturing SOEs (in 100 mil. yuan)	Proportion of SOEs in deficit (%)
1975	130.1	52.0	31.4
1976	164.8	72.5	37.2
1977	140.7	57.5	27.4
1978	115.3	44.3	23.9
1979	116.8	36.9	23.4
1980	140.8	31.9	22.4
1981	126.4	42.4	27.7
1982	196.9	42.7	25.1
1983	239.9	28.6	14.6
1984	199.9	22.9	10.5
1985	258.9	27.1	9.6
1986	417.1	47.1	13.4
1987	481.7	50.7	12.8
1988	520.6	71.3	10.7
1989	749.6	128.0	15.9
1990	932.6	278.8	30.3
1991	925.9	300.2	28.0
1992	756.8	300.1	22.7
1993	479.4	281.7	29.8
1994	624.5	273.8	32.6
1995	802.1	364.8	33.3
1996	1127.0	501.4	37.5
1997	1420.9	607.2	43.9

Note: Proportion of SOEs in deficit = number of mining & manufacturing SOEs in deficit against total number of mining and manufacturing SOEs.
Source: *China's Almanac of Public Finance*, 1998

Table 4 Major Competitors of SOEs (1996)

	Very tough rival	Tough rival	Not so tough rival	No competition
Domestic non-SOEs	49.5	27.3	12.9	10.3
Other SOEs	29.1	41.3	21.1	8.4
Joint ventures with foreign firms	21.1	30.4	23.0	25.5
Foreign imports	18.7	19.8	20.9	40.6

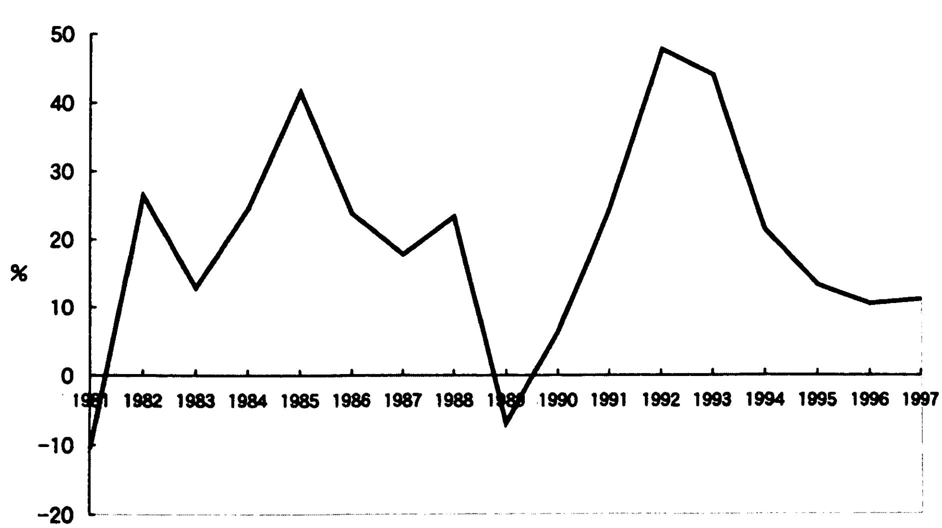
Note: The figures show the share (%) within the total sampled firms.
Source: OECF-RIDA data (800 sample enterprises)

3. SOEs' Soft-Budget Constraint

The backdrop of excessive distribution and excessive investment was the so-called soft-budget constraint on SOEs, details of which will be explained in the next chapter. The principle of the contract responsibility system was that the wage increase rate should be less than a set percentage of the profit and productivity increase rates. It was also assumed that wages might be cut if a firm's performance deteriorated. But in practice, the real wage, including fringe benefits and benefits in kind, rose beyond the profit and productivity growth rates. It was rare that deteriorating performance led to wage cuts (Figure 3). This situation basically continued even after the abolition of the contract responsibility system. The OECF-CASS survey showed that the total wage amount continued to grow by 10-20% in the 1991-95 period while the average pre-tax profit declined in 1993-95.

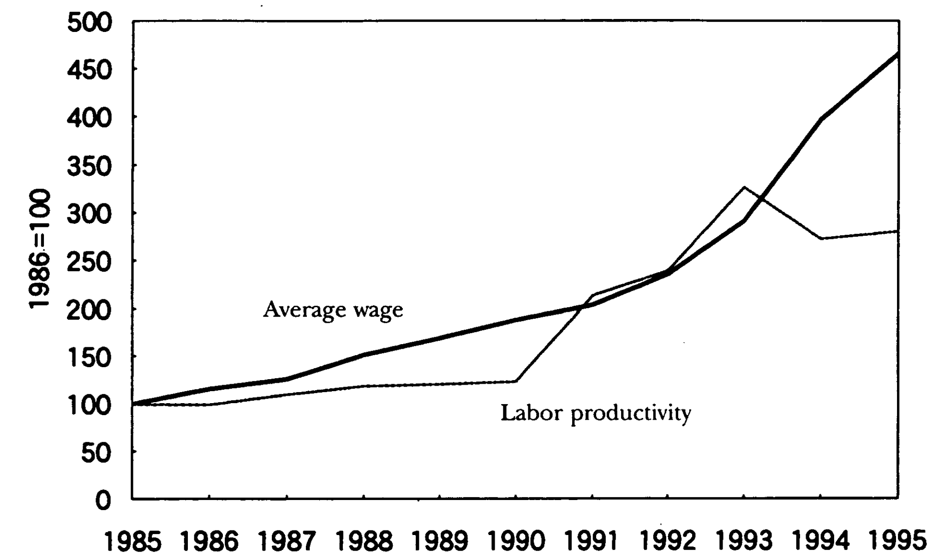
The rule is that a company's profit is squeezed if the wage cost rises. But SOEs borrowed money from state banks to solve the financial difficulties caused by rising wages. Until the beginning of the 1990s, SOEs were able to borrow money without difficulty if they were backed by the government. It is true that the mid-1980s reform gave SOEs profit motivations. But management accountability remained unestablished. Their rights and responsibilities were still asymmetrical. It was this imbalance that invited excessive distribution to labor and excessive investment. Why then were budget constraints soft for SOEs? The reason was that SOEs were expected to play two important social roles, as mentioned before: the provision of jobs to the urban labor force and the promotion of local industrial development.[2] This relationship is illustrated in Figure 4. In the following Sections, we discuss each of the factors shown in the Figure 4.

Figure 2 Growth of Investment in Fixed Assets in the State Sector



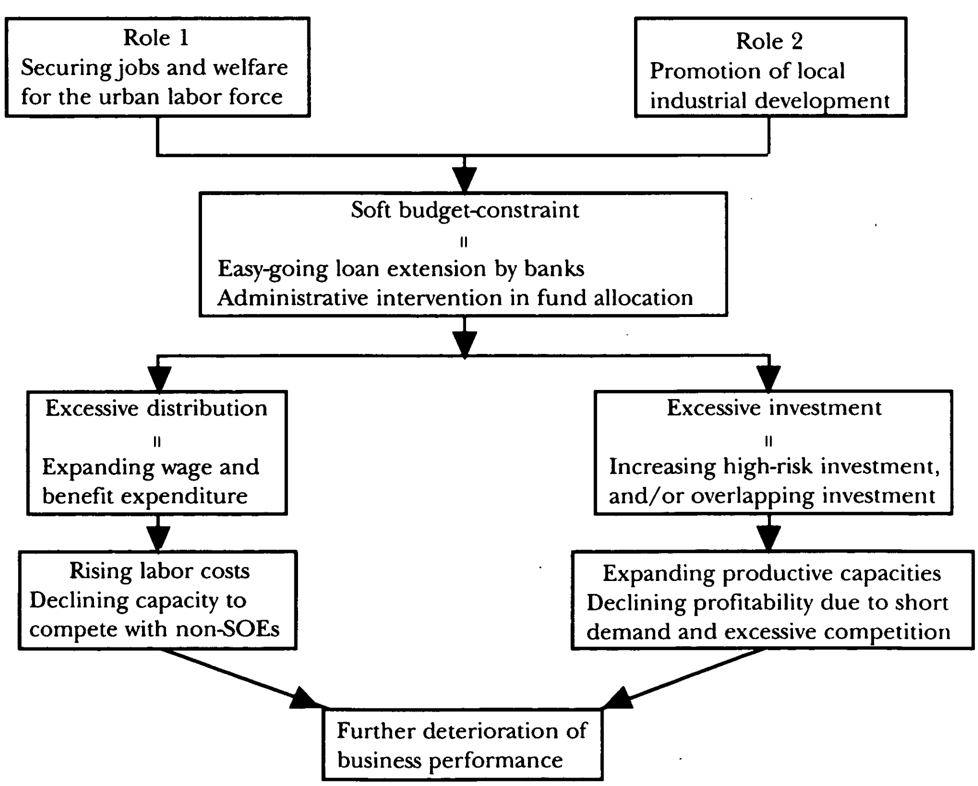
Note: The nominal increase rate of fixed asset investment over the previous year.
Source: *China Statistical Yearbook* (relevant years)

Figure 3 Growth Rates of Average Wages and of Labor Productivity at SOEs



Note: The average wage figures are for enterprises of all business sectors; labor productivity is based on the gross output value of the mining and manufacturing industries.
Source: Made from *China Statistical Yearbook* (in relevant years)

Figure 4 Social Roles of SOEs and Deterioration of their Business Performance



Section 2
SOEs and the Urban Labor Force

1. Surplus Labor Accumulated within SOEs

Since the time of the planned economy, SOEs have played a politically very important role as the absorber of the urban labor force. Faced with high urban unemployment at the inception of the People's Republic of China, the Chinese government, for the sake of political stability, assigned the role of surplus labor force absorber to the SOEs, which had just been established through the government takeover of foreign-invested and national private enterprises as well Kuo Ming Tang established state enterprises. Since then, **SOEs had to continue to absorb new workers — in ever-increasing numbers due to high birth rates — regardless of production needs**. Even during the period of reform and opening-up from the late 1970s onwards, the size of SOE labor forces continued to grow. This trend lasted until the 1990s (Figure 5). The SOE basically continued to act as a buffer to cushion otherwise acute unemployment situations.

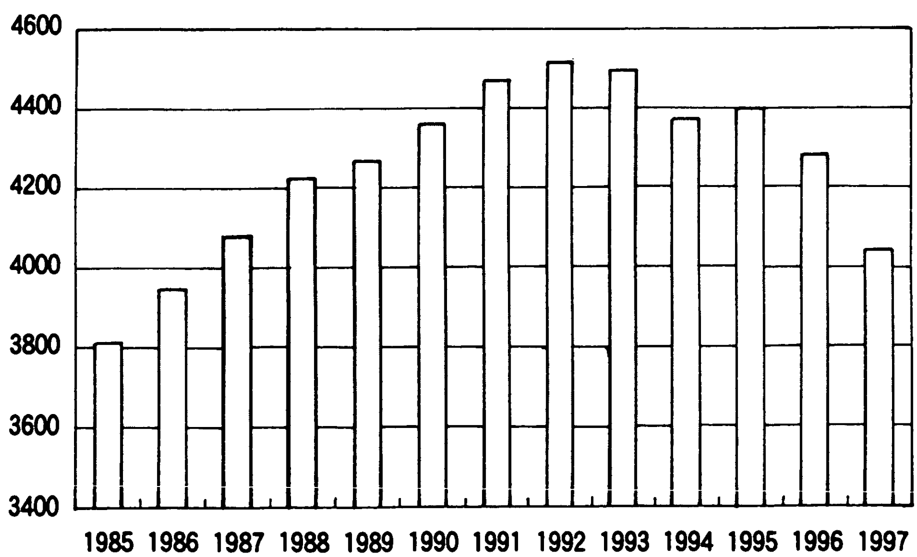
Due to this societal obligation, the SOEs universally ended up with surplus work force in their employ. Various estimates have been made as to the size of the surplus work force. The OECF-CASS survey puts the surplus at 20.8 % of all SOE employees. As the SOE sector at the time of the survey (1996) had 76 million employees (excepting the public service sector), discharging all the surplus workers would have pushed unemployment up to a hefty 11%, based on the OECF-CASS estimate. Unless the dismissed workers were able to move smoothly to other sectors, a serious unemployment problem would be unavoidable.

The Chinese government was very sensitive about the potential emergence of urban unemployment and even when it promoted enterprise autonomy in the second half of the 1980s, it did not permit SOEs to carry out employment adjustment. For this reason, the SOEs had to keep their surplus work force in employment. Employment adjustment started only in the second half of the 1990s as Section 4 explains.

2. Insider Control at SOEs

Labor surplus usually means lower wages. But in China the real wage consistently rose, except during the 1988-89 period of galloping inflation. Housing subsidies and other benefits expanded even more rapidly. A wage increase considered rational in a market economy should be one that corre-

Figure 5 Number of Employees in the State-Owned Mining and Manufacturing Sectors (In 10,000 persons)



Source: *China Statistical Yearbook*, 1998 sponds to the marginal labor productivity. That is to say, the productivity increment and cost increment due to addition of a unit of labor should be kept at the same level. It is known that in the reform and open economy period, the real wage (including welfare benefits) rose beyond the marginal labor productivity of that period.

The major cause for this undisciplined wage raising was insider control of the SOEs. About 70% of the SOE managers were insiders promoted to managerial positions. Though the final say stayed with the supervisory authorities (or party organizations concerned), managers in fact would not function well unless they were supported by the employees. The OECF-CASS survey showed that 55% of the SOEs under survey replied that the employees played a "very important" or "an important" role in the replacement of managers. Given this, the strengthened management authority (austerity) in the contract responsibility period prompted managers to raise wages and provide additional benefits in their effort to gain more support from their employees.

The so-called "supervisory offices" were in a position of supervising the enterprise behavior, but **these offices lacked any strong incentive to restrict excessive distribution to workers.** Excessive distribution of course eats into the enterprise's own funds and thus makes the enterprise dependent on loans. But as already stated, easy bank loans were available to the SOEs until the early 1990s. If an enterprise's finances got tight, the enterprise and its supervisory office would appeal to the need for "social stability" and on these grounds persuade the local government to pressure the local branches of state-owned banks to extend additional loans or to cut or write off interest.

3. Constraints on SOEs' Withdrawal from market

In a market economy a firm performing badly will be finally eliminated in the form of bankruptcy. In China, a bankruptcy law was tentatively introduced in 1988 and became applicable to SOEs. But to date, only a few hundred firms go into bankruptcy every year. A survey conducted at the middle of the 1990s showed that approximately 10% of SOEs were practically bankrupt: about 8,000 SOEs in the mining and manufacturing sectors. All this shows that bankruptcy is not functioning well as a mechanism for weeding out poorly performing firms.

The problematic nature of declaring a state-owned firm bankrupt comes from the firm having carried out its social role as provider of jobs and benefits to urban workers. The government had this in mind when it established the "capital structure restructuring policy", in 1994, for the acceleration of structural adjustment including company bankruptcy. To facilitate the bankruptcy of ill-performing firms, the government enacted a law about liquidation, applicable in designated city areas, whereby the revenue from the disposal of the land use rights of the bankrupt firm should be preferentially appropriated for the payment of unpaid wages and re-employment of its employees. As a result, companies going bankrupt have repaid only a few per cent of the debts they owed at the time of their failure. This constraint in fact thwarts the functioning of the bankruptcy system and allows inefficient firms to stay in the market.

Section 3
SOEs and Industrial Policies

1. Promotion of Industrial Development through SOEs

Like its socialist predecessor, the Soviet Union, China in its planned economy period emphasized as the core of its development strategy the formation of a fully-ranging industrial structure through government investment. **In the period of the reform and open-door policy, the stress of development was shifted to economic growth and enhancement of the standard of living. But its basic approach, namely industrial development through SOEs, has remained basically unchanged.**

One major change in the reform and open-door policy period was that, **as the result of decentralization, local government emerged as the main agent of industrial investment**. Thanks to fiscal reform, local governments became able to retain a sizable portion of their tax revenues. Also, economic achievement began to be highly valued in the assessment of local governments and party cadres. Consequently, local governments had strong incentives to promote local economic growth and industrial development. As Table 1 showed, the overwhelming majority of SOEs are under the control of local governments. The local governments had every reason to made strenuous efforts to promote local industries by setting up new SOEs and investing in existing ones for capacity expansion. **These efforts did work as a booster to high growth but they simultaneously invited colossal waste and inefficiency through excessive investment.**

2. Investment Control by the Government[3]

As shown in Table 2, much progress toward managerial autonomy within SOEs had already been achieved by the mid-1990s. The granting of autonomy in other areas is lagging behind, however. SOEs do not yet have autonomy in investment, for example. In the 1996 OECF-CASS survey, around 70% of the firms in the survey had no autonomy in matters related to investment. Other surveys of enterprise autonomy give similar figures. A survey conducted in the early 1990s of 115 state- and collectively-owned firms indicated that two thirds of the firms surveyed, while admitting that their autonomy had expanded, said that decision-making with regard to investment took place via a combination their own autonomy with government intervention (Lin, et al. [1993], pp.305 to 12). Another survey by the State Planning Committee jointly with local planning committees in 1994 showed that the majority of the respondent local state planning committees and enterprises said that the size of investment was decided by the government (including the chiefs of party organs and administrative units).

The delay in the provision of enterprise autonomy of investment decisions is ascribed to the presence of the administrative appraisal system of investment. When a SOE invests in equipment using bank loans, it has to be screened and approved by the supervisory office responsible for the sub-sector, the investment control authorities, and the planning and economic committee of the local government. If the amount of investment planned is beyond a pre-set ceiling, the enterprise must apply to the central government for screening and approval. The procedures are varied in accordance with provinces and business categories. Here let us take a cotton textile factory Y, in Anyang City in Henan Province, planning to make an innovation investment (based on an interview in March 1996).

Factory Y is a large SOE with 7,400 employees. It belongs to the Textile Industry Corporation of Anyang City (formerly the Textile Industry Bureau). Factory Y first presents a project proposal to the Corporation and then the Economic Committee. The committee, as the local version of the State Economic and Trade Committee, conducts a feasibility study of the project. The factory must go through a series of screening and approval processes, if the proposed investment is over 30 million yuan, beginning with the Textile Industry Bureau of the Provincial Government and the Provincial Economic Committee through the National Textile Council (former Ministry of Textile Industry, now reorganized into the State Bureau of the Textile Industry) up to the State Economic and Trade Committee. When the proposal has reached the National Textile Council, consultation is held with the headquarters of the Industrial and Commercial Bank of China (this being the main lender of the four state-owned banks for technological innovation projects). If this bank agrees to the loan, it opens the necessary credit lines at its Henan provincial and Anyang city branches for the project.

The enterprise itself participates in the first half of the economic committee's feasibility study. The Anyang city branch of the said national bank joins in the second half. It must be at this second stage that the enterprise obtains the bank branch's informal agreement on the loan. Only after that can it proceed to the provincial screening stage. According to a spokesperson at Factory Y, the municipal government plays a very important role in the higher screening processes. In addition, the application to the central agencies is submitted jointly by the enterprise and the provincial textile industry bureau (officers from both traveling to Beijing together).

This chain of procedures is complex and cumbersome. It usually takes about one year from the presentation of the application to the municipal government to the final approval by the central government. Technical innovation loans are usually repayable in three years. As textiles are a low-profit business, Factory Y can expect only to break even after paying interest on state bank loans. But the fund cost would be even higher if it went to other sources, so the company must rely on state-owned banks even if it involves intricate procedures.

3. The Mechanism for Investment Expansion

This system of screening and approval for investments originated in a self-critical evaluation of the planned economy practice. Then, the lack of investment control, it was recognised, led to the expansion of inefficient investments and eventually invited macro economic instability. **Under the new system, local governments were supposed to screen investment plans from the point of view of profitability and industrial policy implementation, in line with the central government's policy of controlling investment scale**. This system was originally intended to have local governments carry out the central government's investment policies.

But in reality, local governments are not a mere mouthpiece of the central government. They have their own interests and motivations. As has already been mentioned, they have incentives to promote industrial development in their respective areas. Thus, whatever the intentions of the central government, the local governments have the tendency to maximize local investment in local industries. The fact that their main financial sources were state-owned banks willing to provide easy money no doubt also spurred their enthusiasm for investment. Once the importance of an investment project had been recognized by the central government, a company could expect to borrow more, even if faced capital stringency. The resultant increasing loan balance of the state-owned banks was finally covered by inflated money supply from the central bank. In this setting, local governments did not have compelling reasons to restrain investment when screening proposed projects. If a project could be useful for the acceleration of growth and promotion of local industries, even if it was a high risk project, local governments would petition actively for central government approval.

4. The Consequence of Government Failure

Government involvement in decision-making on investment had certain justifiable reasons even after the transition process to market economy got under way. In the 1980s the SOEs were taking their first steps as independent business bodies and were inexperienced in the acquisition of market know-how. The supervisory offices, by contrast, had their national administrative networks capable of collecting market and policy information. These offices therefore had to complement the SOEs' activities. In this situation, decisions on investment had to be made jointly by the enterprise and its supervisory office.

But this decision-making mechanism had a serious defect. As was explained above, local governments have strong motivations to expand the scale of their local economy. **Added to this, are the facts that (1) government officials stay in the same post for only a few years, so they are eager to maximize their visible accomplishments during their term of office; (2) in the case of an investment failing to bring about the desired results, the burden is usually borne by the banking sector and is ultimately settled in the form of increased money supply by the central bank**. Subject only to this "soft budget constraint", enterprises and local governments had every reason to increase the scale of production through heavy borrowing.

Until the early 1990s, the increased production output created by debt-financed investment was relatively easily absorbed by the market, where demand always exceeded supply. But China at that time was in the process of throwing off its "economy of shortage," having experienced a whole decade of rapid growth. As part of the path to increased growth, following Deng Xiaoping's speech in South China in early 1992, control of the money supply was relaxed. SOEs and local governments continued with large scale investment. When, in the middle of 1993, growth took a sudden nose-dive due to the money supply being tightened again, the problem of surplus productive capacity was suddenly exposed. The third industrial census held in 1995 showed that the capacity utilization rates had gone down to 60% or less with regard to half of the products covered by the survey.

Section 4
The Government-Enterprise Relationship and Market Competition

1. Aggravated Competition and Changing Government-Enterprise Relationships

As is already clear, the special relationship between local government and enterprises in China generated inefficiency in the form of excessive distribution to workers and excessive investment. In the period of quantitative expansion that lasted until the early 1990s, this inefficiency caused macro-destabilization more than once. The destabilization was covered up by the rapid expansion of the economy, however. **But as growth slackened and**

competition sharpened in and after 1993, the government-enterprise relationship was compelled to change. More managerial autonomy was imparted to enterprises in the areas of investment and employment, allowing enterprises to become more independent of government control. The financial reform introduced in 1993 to 95 modified the budget constraints on both banks and enterprises. This was an important factor in spurring the transformation of the government-enterprise relationships.

2. Fluidization of Employment

It has been explained above how an important traditional function of the SOEs was to guarantee jobs for the urban workforce. In the second half of the 1990s, however, this tradition also had to change as competition became sharper among SOEs whose performance had deteriorated with the declining growth rate.

As the performance of SOEs deteriorated alarmingly from 1997 through 1998, **the government shifted the emphasis of its SOE policy from a time-consuming reform of the enterprise system to structural modifications having immediate bearing on the improvement of business results. This meant that the first priority of reform was shifted to the settlement of the surplus labor-force problem.** In the "Guidelines for Restructuring and Development Policies for SOEs in 1998," the State Economic and Trade Committee stated that for the large and medium-sized SOEs to overcome deficits within three years, "rationalization of surplus personnel is essential." It said that for this "one of the fundamental measures for the promotion of SOEs is to lay off or transfer surplus personnel." Thus, the government for the first time made it clear that full-scale employment restructuring should be carried out. The government decided to facilitate major enterprises' dismissal of surplus workers by providing them with subsidies and debt moratoria. SOEs set out to reduce their workforces in order to improve their business positions.

To minimize social unrest arising from dismissals, the government launched its Re-employment Project in 1997. In this project, those who are earmarked for dismissal are transferred to a re-employment service center set up within the enterprise, where they are paid a basic livelihood wage of 200 yuan or so a month and they undergo professional retraining. The center also helps the unemployed to find new jobs. If the worker concerned fails to move to a new job within three years, he or she is officially dismissed and is entitled to unemployment insurance benefit.

The Re-employment Project is a temporary project effective only until 2002. After this term expires, redundant workers will be simply dismissed without transitory processes. In other words, worker placement services will be totally marketized in 2003.

3. Strategic Re-adjustment of State Capital

The 15th Congress of the Chinese Communist Party (CCP), held in 1997, adopted a new concept: strategic adjustment of the state economy. Having its origin in the mixed ownership policy approved in 1993 by the decision of the third plenum of the 14th Central Committee of the CCP, this concept provides for a further step forward toward **active structural adjustment in the form of state capital's "exit" from some business categories**. In concrete terms, state capital will be withdrawn by stages from the general manufacturing sector while it will stay in the natural monopoly sub-sectors (water and electric services, and railways), the sub-sectors involving security (postal services, communication, and defense), high risk sectors that would discourage private business participation, such as the high-tech sub-sector, and the basic manufacturing sub-sectors such as the automobile industry. The third plenum policy of "*zhua da fang xiao*" ("support large firms and liberalize small firms") will be thoroughly implemented. **Though this policy package is named "strategic adjustment," it envisages de facto privatization of Chinese business**. The adoption of this policy in fact has kicked off new moves toward privatization.

Privatization has so far been promoted mainly for medium and small SOEs and collectively-owned enterprises at the county level or below. The State Statistical Bureau conducted a survey in the first half of 1998 on 60,000 mining and manufacturing firms registered as state-owned at the end of 1996 (67% of the total number of state-owned firms). Of these, 16.5% had been sold, or were being sold, to private interests and 16.1% had become joint stock cooperatives (employee-owned enterprises).

The central government is still cautious about privatization of large and medium-sized SOEs. But at local levels, moves to privatize medium-sized SOEs are beginning to emerge. At the central government level, too, the State Economic and Trade Committee decided to revise the enterprise size classification so as to reduce the number of large and medium-sized enterprises in order to broaden the scope of privatization. (The proposed revision in classification met with criticism from the 1999 National People's Congress and was shelved, however.)

It is worth noting that the number of listed SOEs being privatized through the sale of state-owned shares to private companies has been increasing recently. Since 1997 more than 20 such cases have been reported. This reflects the changing attitude of local governments toward privatization. The local governments are now increasingly inclined to sell the state-owned shares of inefficient SOEs to active and energetic private enterprises. That would bring them more tax revenue and enable them to appropriate the income from the sale for the improvement of local infrastructure and other measures for local economic growth.

Conclusion

As has been shown in this Chapter, local governments, in their capacity as supervisor of SOEs, assigned to SOEs the role of guarantor of local jobs and promoter of local industrial development. SOEs were able to play this role thanks to the "soft budget constraints" allowing state-owned banks to lend them money. The consequences of this were the excessive distribution and excessive investment that brought about poor SOE performance.

In the wake of drastic changes to the business environment from the mid-1990s onward, the relationship between the government and enterprises has begun to change visibly. An enterprise is now required to become an independent actor in the market while being unburdened of its social roles. This change is manifest in the full-scale employment restructuring that began in 1997 following the toughening of financial constraints in the 1993 to 95 financial reform. The government in the past used to demand that an SOE pursue two goals simultaneously – maximization of profit and fulfillment of its social roles. The prevailing business environment would no longer allow this dual goal, so the government has had to permit the SOE to concentrate on profit maximization. With the progress of financial reform, the state-banks are tightening their credit control, making it difficult for SOEs to obtain loans even with the backing of the government.

These transformation of the government-enterprise relationship are obviously positive from the point of view of efficiency of financial systems. It should however be pointed out that the current changes have a certain limit beyond which they cannot proceed. As long as capital is owned by the state, it will be impossible to do away completely with government intervention in company management. In the foreseeable future, the government will remain the single largest investor in SOEs even if combined corporate-ownership spreads. As such, the government will continue to control SOEs' personnel affairs. For Chinese corporate management to gain complete independence and achieve greater efficiency, the system of state-ownership of capital that should be critically examined, and the quest for a new, appropriate style of corporate governance for Chinese companies should be embarked upon.

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(Japanese)

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Notes:

1. This survey was conducted in 1996 over 800 SOEs in the four provinces of Jilin, Sichuan, Jiangsu, and Hunan. For details of this survey, see *Kaihatsu Enjo Kenkyu* (Development Assistance Studies), Vol.4, No.4, 1997.
2. For discussion of the social roles of SOEs and the soft budget constraint, see Imai (1998a) and Lin, et. al. (1997).
3. The argument in this sub-section is based on Imai (1997b).